Risk Management

Da Afghanistan Bank (DAB)

2013

Content

Page

1. Overview …………………………………………………………………….. 3
2. Defining Risk ……………………………………………………………. 4
3. Financial Risk ……………………………………………………………. 5
4. Credit Risk …………………………………………………………….. 5
5. Foreign Exchange Risk ……………………………………………….. 6
6. Interest Rate Risk 6
7. Liquidity Risk ……………………………………………………………. 7
8. Operational Risk ………………………………………………………. 8
9. Reputational Risk 8
10. Risk Management Department …………………………………………….. 9
11. Risk Management ………………………………………………………. 9
12. Risk Management Framework ……………………………………………... 11
13. Risk Management Department's Organ Gram………………………………... 12
14. Technical Assistance ……………………………………………………….. 13

Overview

Several global factors are encouraging central banks to strengthen their practices in the areas of transparency, financial management and corporate governance. These include:

• **Leading by example.** Central banks are among the government agencies responsible for implementing international measures aimed at strengthening global and domestic financial systems. This role has encouraged central banks to promote international best practice in areas such as corporate governance, management accountability, financial disclosure and risk management for banks and other financial institutions. In pursuing these reforms, central banks inevitably come under pressure to lead by example, through their own adoption of improved management and transparency practices.

• **Increased central bank independence.** The last decade or so has seen a number of countries implement monetary policy reforms which have involved conferring a degree of operational independence on the central bank to implement monetary policy. Increased independence carries with it the need for greater transparency of decision-making and accountability, not only in respect of monetary policy, but also in respect of a central bank's other functions and the management of its resources. In turn, that has put a premium on the need for strengthened corporate governance, financial disclosure and risk management practices within central banks.

• **Emphasis on central bank best practice.** In recognition of the importance of the central bank's role in the economy, and the increasing emphasis on strengthening risk management practices and governance within public and private sector entities, there is increasing international emphasis on the need for best practice for central bank operations. Central banks have been expected to adopt specific international recommendations aimed at strengthening governance, transparency and financial management.

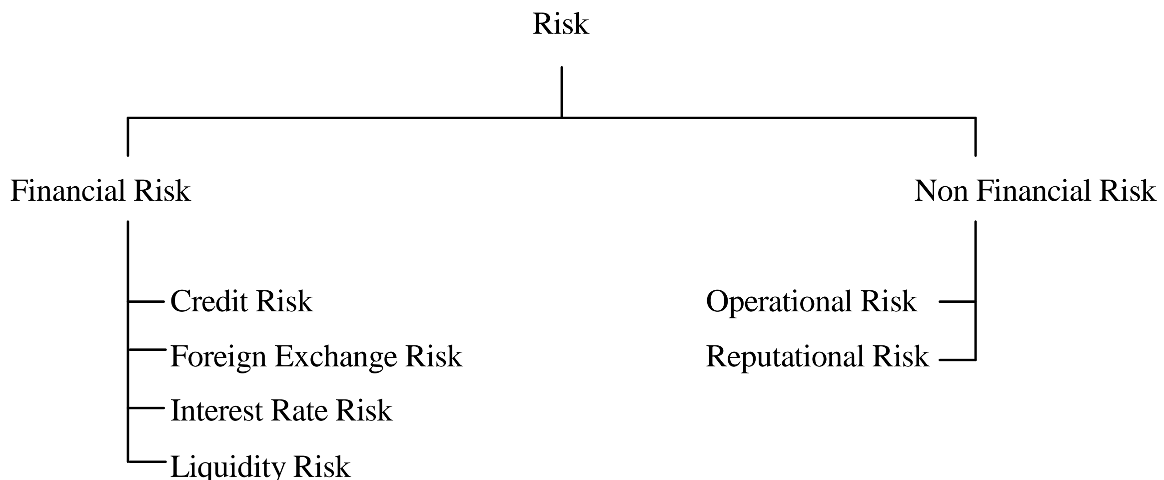
These factors have provided impetus for central banks to improve their operations in all areas.

Defining Risk

For the purpose of these guidelines financial risk in banking organization is possibility that the outcome of an action or event could bring up adverse impacts. Such outcomes could either result in a direct loss of earnings / capital or may result in imposition of constraints on bank's ability to meet its objectives.

However, the central bank is not exposed to all the risks that a commercial bank faces. This mainly reflects that the bank is involved in policy-orientated activities rather than the profit orientated activities typical of commercial banks and that the bank's financial operations are different to those of a commercial bank. In addition, the bank is exposed to different risks such as the risk associated with policy outcomes. Therefore, the Bank's risk management framework necessarily differs from the risk management frameworks for commercial banks.

Risks are usually defined by the adverse impact on profitability of several distinct sources of uncertainty. While the types and degree of risks an organization may be exposed to depend upon a number of factors such as its size, complexity business activities, volume etc, it is believed that generally the banks face Financial Risk (i.e. Credit, Market, Liquidity), Operational, Compliance / legal /regulatory and reputation risks.



Financial Risk

Financial risk management arrangements for central banks are fairly similar to those in place in commercial banks. Da Afghanistan Bank can face significant financial risks in their operations, given that they typically hold some volumes of financial instruments. The risks include:

•**Credit Risk** on local and foreign currency assets
• **Exchange Rate Risk**: - foreign currency risk from the management of foreign reserves;
•**Interest Rate Risk** on foreign and local currency assets and liabilities;
•**Liquidity Risk** associated with the management of foreign reserves; and

Credit Risk

Credit risk arises from the potential that an obligor is either unwilling to perform on an obligation or its ability to perform such obligation is impaired resulting in economic loss to the bank.

In a bank's portfolio, losses stem from outright default due to inability or unwillingness of a customer or counter party to meet commitments in relation to lending, trading, settlement and other financial transactions. Alternatively losses may result from reduction in portfolio value due to actual or perceived deterioration in credit quality. Credit risk emanates from a bank's dealing with individuals, corporate, financial institutions or a sovereign. For most banks, loans are the largest and most obvious source of credit risk; however, credit risk could stem from activities both on and off balance sheet.

In addition to direct accounting loss, credit risk should be viewed in the context of economic exposures. This encompasses opportunity costs, transaction costs and expenses associated with a non-performing asset over and above the accounting loss.

Credit risk can be further sub-categorized on the basis of reasons of default. For instance the default could be due to country in which there is exposure or problems in settlement of a transaction.

Credit risk not necessarily occurs in isolation. The same source that endangers credit risk for the institution may also expose it to other risk. For instance a bad portfolio may attract liquidity problem.

Foreign Exchange Risk

It is the current or prospective risk to earnings and capital arising from adverse movements in currency exchange rates. It refers to the impact of adverse movement in currency exchange rates on the value of open foreign currency position. The banks are also exposed to interest rate risk, which arises from the maturity mismatching of foreign currency positions. Even in cases where spot and forward positions in individual currencies are balanced, the maturity pattern of forward transactions may produce mismatches. As a result, banks may suffer losses due to changes in discounts of the currencies concerned. In the foreign exchange business, banks also face the risk of default of the counter parties or settlement risk. While such type of risk crystallization does not cause principal loss, banks may have to undertake fresh transactions in the cash/spot market for replacing the failed transactions. Thus, banks may incur replacement cost, which depends upon the currency rate movements. Banks also face another risk called time-zone risk, which arises out of time lags in settlement of one currency in one center and the settlement of another currency in another time zone. The forex transactions with counter parties situated outside Pakistan also involve sovereign or country risk.

Interest Rate Risk

Interest rate risk arises when there is a mismatch between positions, which are subject to interest rate adjustment within a specified period. The bank's lending, funding and investment activities give rise to interest rate risk. The immediate impact of variation in interest rate is on bank's net interest income, while a long term impact is on bank's net worth since the economic value of

bank's assets, liabilities and off-balance sheet exposures are affected. Consequently there are two common perspectives for the assessment of interest rate risk.

Interest rate risk occurs due to :

(1) differences between the timing of rate changes and the timing of cash flows (**re-pricing risk**);

(2) changing rate relationships among different yield curves effecting bank activities (**basis risk**);

(3) Changing rate relationships across the range of maturities (**yield curve risk**); and

(4) interest-related options embedded in bank products (**options risk**).

Liquidity Risk

Liquidity risk is the potential for loss to an institution arising from either its inability to meet its obligations or to fund increases in assets as they fall due without incurring unacceptable cost or losses.

Liquidity risk is considered a major risk for banks. It arises when the cushion provided by the liquid assets are not sufficient enough to meet its obligation. In such a situation banks often meet their liquidity requirements from market.

However conditions of funding through market depend upon liquidity in the market and borrowing institution's liquidity. Accordingly an institution short of liquidity may have to undertake transaction at heavy cost resulting in a loss of earning or in worst case scenario the liquidity risk could result in bankruptcy of the institution if it is unable to undertake transaction even at current market prices.

Banks with large off-balance sheet exposures or the banks, which rely heavily on large corporate deposit, have relatively high level of liquidity risk. Further the banks experiencing a rapid growth in assets should have major concern for liquidity.

Liquidity risk may not be seen in isolation, because financial risk are not mutually exclusive and liquidity risk often triggered by consequence of these other financial risks such as credit risk,

market risk etc. For instance, a bank increasing its credit risk through asset concentration etc may be increasing its liquidity risk as well. Similarly a large loan default or changes in interest rate can adversely impact a bank's liquidity position. Further if management misjudges the impact on liquidity of entering into a new business or product line, the bank's strategic risk would increase.

Operational Risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and system or from external events.

Operational risk is associated with human error, system failures and inadequate procedures and controls. It is the risk of loss arising from the potential that inadequate information system; technology failures, breaches in internal controls, fraud, unforeseen catastrophes, or other operational problems may result in unexpected losses or reputation problems. Operational risk exists in all products and business activities.

Operational risk event types that have the potential to result in substantial losses includes Internal fraud, External fraud, employment practices and workplace safety, clients, products and business practices, business disruption and system failures, damage to physical assets, and finally execution, delivery and process management.

Failure to understand and manage operational risk, which is present in virtually all banking transactions and activities, may greatly increase the likelihood that some risks will go unrecognized and uncontrolled.

Reputational risk

Overarching the categories of financial, operational and policy risk is reputational risk. Reputational risk can be viewed as secondary, in that reputational damage usually is caused by a

loss or failure in the areas of policy, operations or finance. But given the importance of credibility to central banks, reputational damage can be their greatest concern. In a 2003 BIS survey (BIS (2003b), the vast majority of respondents reflected the view that continued reliance on the central bank as an independent authority with the necessary financial resources ultimately depends on trust in the institution.

Reputational risks can occur when there is a mismatch between public perceptions and the actual objectives and resources of the central bank. Serious misconduct, human or system failures or major difficulties in meeting objectives are not frequent among central banks, but they can seriously damage credibility when they do occur. Questions concerning ethical conduct and core principles such as honesty and integrity can pose a more severe test than purely legal issues, such as litigation against the organization.

Risk Management Department

Risk Management Department of Da Afghanistan Bank (DAB) will be responsible for developing and maintaining the risk management framework of the DAB which encapsulates the development of policy and processes, tools and methodology as well as promoting effective best practices. It oversees the implementation of the framework, and ensures that risk management processes are appropriately carried out.

Risk Management.

Risk Management is a discipline at the core of every financial institution and encompasses all the activities that affect its risk profile. It involves identification, measurement, monitoring and controlling risks to ensure that

a) The individuals who take or manage risks clearly understand it.

b) The organization's Risk exposure is within the approved limits.

c) Risk taking Decisions are in line with the strategy and objectives.

d) The expected payoffs compensate for the risks taken.

e) Risk taking decisions are explicit and clear.

The main financial risks, DAB are exposed to include credit risk on foreign currency reserves and interest rate risk on both foreign and local currency assets and liabilities. In the management of its reserves, DAB also has an exposure to liquidity risk. Like most other central banks, the nature of the DAB's operations creates exposure to a range of operational risks and reputation risk.

Bank management should ensure that strong and effective risk analysis, management and control systems are in place for assessing, monitoring and managing risk exposure. A Risk Management Committee, comprising senior management, is responsible for advising the Governor on the monitoring and management of all risks that the Bank faces. Comprehensive guidelines control the manner in which the Bank conducts local currency, foreign currency reserves management and foreign exchange dealing operations. The guidelines should contain specific provisions designed to manage the risk associated with each operation and are subject to periodic internal review.

The overall risk management framework should be designed to ensure that an appropriate incentive structure is created for the management of the Bank's risks. The Bank ensures the risk management framework is consistent with financial market best practice and it periodically engages external experts to assist in reviewing and modifying risk management practices and processes.

The Bank should provide information concerning its general risk management framework and information specific to interest rate, credit, foreign currency and liquidity risk as part of the annual financial statements. This information provides both general and specific information concerning the nature of the Bank's risk management framework and indicates the degree of risk the Bank is exposed to in each major risk area.

Risk Management Framework

A risk management framework should encompass the scope of risks to be managed, the process/systems and procedures to manage risk and the roles and responsibilities of individuals involved in risk management. The framework should be comprehensive enough to capture all risks DAB is exposed to and have flexibility to accommodate any change in activities. An effective risk management framework includes.

a) Clearly defined risk management policies and procedures covering risk identification, acceptance, measurement, monitoring, reporting and control.

b) A well constituted organizational structure defining clearly roles and responsibilities of individuals involved in risk taking as well as managing it. Banks, in addition to risk management functions for various risk categories may institute a setup that supervises overall risk management at the bank. The structure should be such that ensures effective monitoring and control over risks being taken.

c) There should be an effective management information system that ensures flow of information from operational level to top management and a system to address any exceptions observed. There should be an explicit procedure regarding measures to be taken to address such deviations.

d) The framework should have a mechanism to ensure an ongoing review of systems, policies and procedures for risk management and procedure to adopt changes.

Risk Management Department

- Director General — Grade 13
  - Admin Assistant — Grade 3
  - Deputy D. G, Financial Risk Division — Grade 11
    - Portfolio & Interest rate risk Section Director
      - Manager, Grade 8 — Officer, Grade 7
      - Manager, Grade 8 — Officer, Grade 7
    - Liquidity & Foreign Exchange rate Risk Section Director
      - Manager, Grade 8 — Officer, Grade 7
      - Manager, Grade 8 — Officer, Grade 7
  - Deputy D.G, Non Financial Division — Grade 11
    - HR & Banking Operations Risk Section Director
      - Manager, Grade 8 — Officer, Grade 7
      - Manager, Grade 8 — Officer, Grade 7
    - IT System Services & Procurement Risk Section Director
      - Manager, Grade 8 — Officer, Grade 7
      - Manager, Grade 8 — Officer, Grade 7

Technical Assistance

Da Afghanistan Bank's Risk Management Department will be a brand new department after its mandate changes. Therefore the dept. needs

- A qualified & well experienced advisor
- Intensive training programs in and out of the country.
- Study visit to other regional central banks, i.e. SBP, RBI, BNM, Turkish Central Bank, etc.